

## Market Fragmentation

Speech by Ryozi Himino, Vice minister for international affairs,  
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Thank you, Scott [O'Malia], for your kind introduction. Good morning, everyone.  
Today, I would like to talk about market fragmentation.

### Resilience and openness

During the last decade, the global regulatory community has pursued dual goals. First, enhancing the resilience of the global financial system and, second, reserving its open and integrated structure.

To attain the first objective, regulations after regulations were piled on.

The Japan FSA was among the first to argue that the world needs both stability and growth, not just stability, that the 140 committees and subgroups in Basel and Madrid should not continue to invent and prescribe strong medicines endlessly, that the cumulative effects and side-effects of regulatory reforms as a whole should be assessed, and that we should not rely only on static regulations but instead focus more on dynamic supervision.

Three years ago, the JFSA's voice was an isolated one. Today, it is the Financial Stability Board's party line to pivot from policy development towards dynamic implementation of reforms and evaluation of their effects.

The second goal has been the preservation of the open and integrated structure of the global financial system, or preventing it from being fragmented along national borders. On this front, there are both good and bad news.

The good news is that, after ten years of intensive work and overcoming several critical impasses at Basel meetings, we now have a new set of globally agreed regulatory standards.

It is also good news that, contrary to some earlier speculation, the U.S. financial regulators have continued to emphasize the important roles that multilateral regulatory cooperation plays.

The bad news is that the trust between authorities has not been lifted to the level needed to smoothly implement cross-border resolution of systemically important financial institutions. It is not uncommon that an authority, which

adopts a single-point-of-entry strategy when acting as a home authority, flexes its muscle for ring-fencing when acting as a host authority.

Brexit may add to the risk of the emergence of a regulatory framework less tolerant of the cross-border provision of financial services by third-country firms.

Moreover, as the financial regulations grow in their body and complexity, myriad technical differences in national regulations are creating unintended impediments to cross-border transactions and activities.

My impression from interactions with market participants is that, in spite of the good news, concerns over market fragmentation are growing.

### Smarter globalization

However, I do not think that we should aim for the full elimination of national regulatory differences, gold plating or extraterritorialities. Authorities operate under national or regional democratic oversight and are primarily responsible for their own depositors and consumers. National priorities may differ depending on developmental stage, culture, and market structure.

We cannot and should not aim for full harmonization of regulations.

More and more goods, services, people, information and money flow across borders. The benefit of globalization continues to grow exponentially, but the side effects of globalization grow as well.

I believe the net benefit is enormous, but the anti-globalization sentiments grow together with the increase in the gross size of the side effects.

And the sentiments are amplified by the dazzling technological developments, which make many to feel that they are left behind.

Economic historians argue that the latter half of the 19th century and early 20th century were another period of rapid globalization, but we all know that this ended up leading to the Second World War.

We need to cope with this age of paradox, whereby globalization reinforces anti-globalization.

We need to do so by mitigating side effects using the regulatory power scattered across nation states, regional unions and global standard setters. This is indeed a painful process. One regulatory response tends to create other cross-border inconsistencies and further side effects.

This is painful for regulators, but it would be all the more so for the members of industry, who need to abide by conflicting regulations without knowing when the reconciliation will happen, and, more importantly, the pain might also be felt by customers in the form of limited availability of services or increased cost.

We, however, need to be patient: There is no easier way other than to solve problems one by one. We also need to be effective: If we are caught up in bureaucratic inefficiencies or political gaming, then the risk of repeating the history of the last globalization cycle may become a reality.

We also need strategy. For several years I have argued for “smarter globalization” of financial regulations, an approach to differentiate the degree of expected cross-border consistency depending on the nature of the regulation.

We have designed and implemented international regulatory standards assuming global consistency is usually a good thing. Each regulatory area, however, has different reasons for cross-border consistency and different needs to be tailored to national specificities. There are many good and bad reasons for setting standards globally and also for tailoring regulations nationally.

Good reasons for global standard setting include promoting good practices and preventing a race to the bottom, preventing negative spill-overs, pooling scarce expert resources, reaping the benefits of common metrics and languages, reducing arbitrage opportunities, avoiding impositions of conflicting requirements, reducing compliance costs, and leveling playing fields.

The most typical bad reason for resorting to global standard setting is to shortcut the painful process to persuade domestic stakeholders.

The most important reason for tailoring regulations nationally is to reflect differences in developmental stages, market structures and policy priorities.

The most typical bad reason for national discretion is to conceal the vulnerabilities unique to the country. This kind of special treatment may work as a short-term pain killer but often results in bigger calamities afterwards.

A review of these elements may help us find approaches for a smarter globalization of regulations, which would provide more granular guidance where conflicting requirements can hinder cross-border activities, while securing more roles for national regulators in areas with limited spill-overs.

That may also help allocate accountability burden better between international standard setting bodies and national regulators.

For example, cross-border consistency in margin requirements on OTC derivatives is a prerequisite for a cross-border transaction. Inconsistencies can fragment the market, while the need to differentiate requirements among major financial centers is relatively low.

On the other hand, there is no need to make capital adequacy regulations for community banks identical across borders. Regulators should assume domestic accountability without relying on Basel as an excuse too much.

If we continue to try to harmonize everything, then the side effects of globalization may be more keenly felt, encouraging further the growth of anti-globalization sentiment.

By taking a cautious approach to expanding the international standard setting work to areas where we cannot demonstrate a clear need for cross-border consistency, we will have a better chance for enlisting public support for deference to international standards in the area where market fragmentation really needs to be avoided.

#### Four sources of fragmentation

And there indeed are areas where discrepancies and overlaps of national/regional regulations have put unnecessary or excessive burden on cross-border activities, increasing the risk of harmful market fragmentation and regulatory arbitrage.

In my view, there are four types of harmful regulatory fragmentation which unduly increase the risk of market fragmentation: discrepancies, overlaps, desynchronization, and competition.

An example of discrepancies is incompatible home and host regulations, one requiring certain conducts while the other prohibiting them.

Overlaps include an external application of national rules imposing different regulatory requirements on the two counterparties of a single transaction.

Desynchronization refers to implementation of an internationally agreed standard by jurisdictions at different timings.

Competition points to regulatory actions taken by authorities in order to secure resources or activities within their own jurisdictions.

Let me talk about the four one by one.

#### Discrepancies

First, discrepancies. There are many cases of incompatible requirements being imposed by different authorities to the same financial institution.

Authority A may request a bank never to tell anyone about the forthcoming sanctions, but Authority B might impose another sanction on the bank for not having reported to Authority B in advance.

A host authority's demand to establish a single local holding company for all operations may conflict with the home authority's demand to separate corporate chains for different activities.

A home authority might demand that the global KYC control has to be audited by the headquarters, while a host authority might not allow personal data to leave its territory.

What can we do to alleviate the problems caused by such discrepancies?

What if countries agree on a simple process to address conflicts between national regulations, like the following one?

If a financial institution operating in two countries faces conflicting requests from two regulators, it will submit a letter describing the conflict to the two regulators.

Then the bank and the two regulators will have a two-hour conference call within, say, three weeks of the submission of the letter.

Within six weeks, each regulator will write a short response and publish an outcome document, which comprises the bank's initial letter and the two responses, on their websites.

This proposed process would not eliminate cross-border inconsistencies. But it will provide transparency and accountability. It will at least make policy makers aware of the pain they create.

### Overlaps

The second category is the overlap. For various policy reasons, jurisdictions incorporate extraterritoriality in their regulations.

Such practice results in the application of two different regulatory regimes on the same market or transaction. It often leads to market fragmentation as market participants try to avoid regulatory duplication by choosing their counterparties.

As mentioned already, we should not aim to fully eliminate extraterritoriality. But there could be some useful practical steps we can take to alleviate the unnecessary pain the overlap creates.

For example, a best practice guidance on the designing phase of a national regulation with explicit extraterritorial effects may work to reduce the risk of market fragmentation. It could describe, for example, how a national authority can identify and consult with potential stakeholders in the early phase of the design.

The Japan FSA engaged with overseas players when designing its regulatory framework on high-frequency traders. I believe that the engagement helped us a lot in calibrating the requirements on overseas traders.

A more ambitious exercise could be the production of a range of practice paper on how national/regional authorities can assess other jurisdictions' regulatory regimes on an outcome basis.

While an article by article comparison would require a relatively simple judgement, a comparison of outcomes tends to be more complex.

This issue could be addressed by benchmarking on internationally agreed standards where they exist rather than on gold-plated national rules, enlisting

both legal and market experts in assessment teams, or a more focused and simplified questionnaire process.

It is up to individual authorities to design their own processes, but other authorities' practices may work as helpful resources.

IOSCO's Cross-border Task Force published a report in 2015 and provided a toolkit for addressing cross-border regulatory issues. If it could be updated with more focus on recognition between authorities, that would be highly valuable.

The CFTC leadership's recent initiatives also present new approaches to the issue of duplication. I am very keen to hear what Commissioner Behnam should say at this conference today.

### Desynchronization

The third category is desynchronization, or the staggered implementation of internationally agreed standards by different authorities.

Diverse timelines adopted by jurisdictions and their repeated slippage in implementing margin requirements for non-centrally cleared derivatives was a case in point.

The desynchronized implementation heightened the risk to the financial stability during transition as well as increased the costs for market participants and regulators.

Already there exist extensive peer review and surveillance processes on the implementation of internationally agreed standards.

Under the guidance of Chairman Ingves of the Basel Committee, I led the launch of the Basel III implementation monitoring framework, together with color coded charts which summarize the outcome of the monitoring, when I was the chair of the committee's Standard Implementation Group.

The framework, which is now called Regulatory Consistency Assessment Process, is still used by the Basel Committee, and similar approaches have been adopted by other standard setters as well.

The consistency of implementation of Basel III has been much better than was the case for Basel II, which was after all not implemented by the United States.

However, there still remain cases of desynchronized implementation. There are several elements of Basel III which should have been implemented in 2017 or should be implemented in 2018 or 2019, but it is not envisioned that jurisdictions will implement them as agreed.

I wonder if the standard setting bodies, taking stock of their activities over the last decade, could start considering how the standard setting could incorporate considerations for timely implementation across jurisdictions.

Simpler and clearer standards with limited need for institution-specific authorization would have a greater chance of timely implementation.

There should also be other useful things we can do to foster timely implementation.

### Competition

The fourth category is competition. Jurisdictions use regulations, such as location policy, ring-fencing regimes, or internal TLAC requirements, to secure resources or activities within their own jurisdictions.

Such competition can be heightened by a lack of trust between authorities or the desire to attain regulatory autonomy over the markets which are critical to the jurisdiction.

Addressing this fourth category is by far the most difficult, as the issues often involve elements of a zero-sum game between jurisdictions.

However, we need to be attentive to the possibility of domino effects, retaliations and escalations. The U.S. introduced the Intermediate Holding Company requirement, and the EU followed suit by contemplating the Intermediate Parent Undertakings requirement.

These may lead to trapped pools of resources and could make problems worse during a systemic event, but given the prisoner's dilemma element in the game, Japan and other jurisdictions might be compelled to do the same in the end.

The walls will proliferate and become higher. Such outcome would be in no one's interest.

I believe that the last category also deserves the attention of the global regulatory community.

### Conclusion

Fragmentation can impair financial stability by reducing market liquidity and trapping scarce resources. It can drag efficiency and economic growth. Combatting market fragmentation should be our common goal.

The G20 leaders in Pittsburgh in 2009 declared, "We are committed to take action at the national and international level to raise standards together so that our national authorities implement global standards consistently in a way that ensures a level playing field and avoids fragmentation of markets, protectionism, and regulatory arbitrage."

They also stated in Saint Petersburg in 2013, "We agree that jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar

outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes.”

These commitments are all the more relevant today and, to fulfil them, more needs to be done.

The Japan FSA is an integrated regulator of banks, insurance companies and capital markets. The agency participates in a wide range of international fora.

We have been proposing to our counterparts and at various fora to start addressing the risks of market fragmentation and to take actions.

I was in Ottawa on Monday this week to participate in the meeting of the Financial Stability Board. I am pleased that the FSB, in its press release issued after the meeting, announced that it added to its work program an initiative to explore ways to address the risk of market fragmentation.

Putting the market fragmentation initiative on the FSB agenda is a major step forward, but it is only a beginning.

The Japan FSA wants to see to it that the initiative will proceed as a forward looking and action oriented one, which addresses future risks and is focused on finding practical solutions.

I would appreciate it if ISDA members could help us identify harmful forms of regulatory fragmentation and explore possible solutions going forward.

Thank you.